Mexico: High Costs of Maintaining Austerity [redacted]

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President Miguel de la Madrid is strengthening the austerity program he introduced last December with tough new initiatives on wage, subsidy, and administrative policies. He appears willing to test the limits of what is necessary to stay in compliance with the IMF stabilization program, even though meeting economic and financial targets is provoking more severe economic problems than international financiers or the Mexican Government had foreseen. [redacted]

Strong determination and skillful negotiating tactics have ensured de la Madrid the support of organized labor and earned him the grudging cooperation of business and the middle class. It is, however, becoming much harder to maintain consensus. Import and public spending cuts are sharply reducing economic activity, bankruptcies and job losses are multiplying, real wages and personal incomes are plummeting, and inflation is staying near triple digits. [redacted]

We believe that in the next few months worsening economic conditions will force Mexico City to seek adjustments in IMF restrictions on the public-sector deficit, money supply expansion, and overseas borrowing to hold the fall in employment and consumption to politically acceptable limits. Even if de la Madrid eases austerity, the steep economic decline is likely to persist throughout this year. If he continues to stand tough, Mexico would be in a more favorable foreign exchange and inflation position for regaining some economic momentum, perhaps by late 1984. [redacted]

Austerity Bites Deep

Meeting IMF Targets. De la Madrid has been moderately successful in managing his austerity program by devaluing the peso, restraining wages, cutting government spending, and freeing most price controls. In May, the IMF characterized austerity implementation as forceful, and—based on preliminary data—judged Mexico in compliance with first-quarter program objectives. More recently, the US Embassy indicated that Mexican officials expect to pass second-quarter targets also—but by a much less comfortable margin. [redacted] 25X1

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We believe Mexico City cut its budget deficit during the first half of 1983 to some 10 percent of GDP—from 18 percent of GDP in 1982—despite a falloff in tax revenues. The 1983 budget mandated a 20-percent real cut in non-debt-related spending and a 20-percent increase in revenues. Reduced spending—largely reflecting trimmed capital goods imports—appears to be at or below target, and the government has just announced further sharp reductions in food subsidies. Tax revenues, however, have sagged with lower world oil prices and declining revenues from business and personal income taxes. [redacted] 25X1

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Implementation of the IMF austerity program has slashed foreign purchases and enabled Mexico to meet its external financial targets and build foreign exchange reserves somewhat. We estimate that Mexican imports during January-June were 60 percent below the level during the same period in 1982. This boosted Mexico's trade surplus to $6.6 billion during the first half of the year, allowed $4.8 billion in interest payments on the foreign debt, and pushed the current account into surplus. Capital flight continued but at levels that were offset by the new foreign loans allowed under the stabilization program. [redacted]

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Mexico: Foreign Financing Gap

Million US $
(except where noted)

	1975	1980	1981	1982 [a]	1983 [a]		
					Jan-Jun	Jul-Dec [b]	Jul-Dec [c]
Trade balance	−3,159	−1,471	−3,003	7,802	6,550	3,250	6,950
Exports, f.o.b.	3,540	17,015	20,927	22,224	10,550	11,250	10,950
Oil and gas	464	10,306	14,441	16,362	7,500	7,500	7,500
Manufactures	1,831	3,726	3,797	3,742	1,900	2,400	2,100
Agriculture	892	1,544	1,481	1,233	650	750	750
Minerals	353	1,439	1,208	887	500	600	600
Imports, f.o.b.	6,699	18,486	23,930	14,422	4,000	8,000	4,000
Net services and transfer	−1,284	−5,290	−9,541	−10,486	−4,650	−5,650	−5,350
Interest	−1,437	−5,437	−8,383	−10,879	−4,750	−5,650	−5,650
Current account balance	−4,443	−6,761	−12,544	−2,684	1,900	−2,400	1,600
Debt amortization due	1,058	5,984	6,310	8,500	4,000	4,000	4,000
Financial gap	**−5,501**	**−12,745**	**−18,854**	**−11,184**	**−2,100**	**−6,400**	**−2,400**
Medium- and long-term capital inflows	5,431	12,460	18,006	16,698 [d]	5,500 [d]	20,500 [d]	−17,500 [d]
Net short-term capital (errors and omissions)	215	1,173	1,962	−8,514	−2,400 [e]	−13,100 [e]	−13,100 [e]
Changes in reserves	145	888	1,114	−3,000	1,000	1,000	2,000
Other financial items							
External debt, yearend	17,600	50,700	74,900	80,800	NA	86,800	83,800
Short term	5,200	11,100	22,500	23,200	NA	10,000	10,000
Debt service ratio (*percent*)							
Due	35.0	45.6	47.7	63.1	56.3	59.4	60.5
After debt relief	35.0	45.6	47.7	46.8	36.9	40.9	41.7

[a] Estimated.
[b] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[c] Assumes Mexico City keeps imports and public-sector spending at rock bottom rates through 1983.
[d] Includes $4 billion in 1982, $1 billion in first-half 1983, and $5 billion in second-half 1983 in debt relief on medium- and long-term debt principal due; and $1 billion in first-half 1983 and $12 billion in second-half in rescheduling of short-term into long-term obligations.
[e] Includes rescheduled short-term debt and arrears, and capital flight.

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Domestic Economic Tailspin

Output. Financial restraints have provoked growing domestic economic problems, however. We calculate that economic activity fell at an annual rate of about 6 percent during January-June.

Import shortages have hit industrial production hardest. Continuing price controls on basic commodities and shortages of imported raw materials, intermediate goods, machinery, and spare parts have eliminated profits for many firms and led to numerous bankruptcies and plant shutdowns. During the first half of 1983, idle capacity in industry grew rapidly; the 163 largest industrial firms were operating at two-thirds capacity, down from 90-percent capacity in 1982, according to a Bank of

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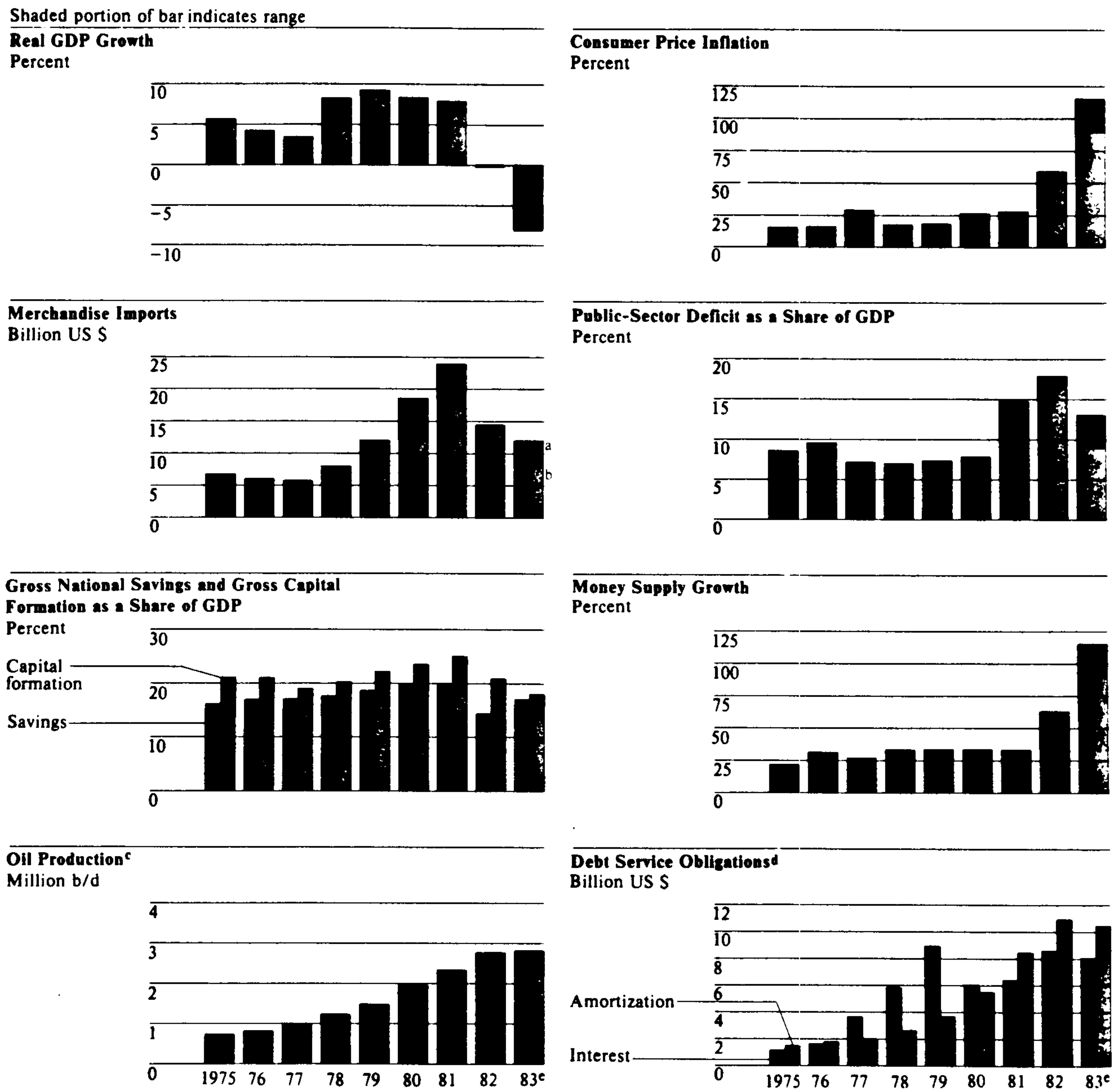
Mexico: Economic Indicators



[a] Assumes Mexican policy makers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.
[c] Excluding natural gas liquids.

[d] Interest on all debt, amortization due on medium- and long-term only; in 1982 debt moratorium and private sector arrears lowered actual debt payments $5 billion, in 1983 we expect debt rescheduling to reduce actual payments on interest and medium- and long-term debt by about $7 billion.
[e] Projected.

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Mexico survey. On the basis of first-quarter data released by the Mexican treasury, we estimate that industrial production dropped at an annual rate of 12 percent during the first half of 1983.

Other sectors are also declining. We estimate that public and private construction activities are off nearly 75 percent. Traditional commercial activities have been cut sharply by the falloff in industrial output and imports and by the higher value-added tax. The outlook for agriculture is also poor because of falling real farm price guarantees and growing shortages of fertilizers, machinery, and other imported inputs. Even the minerals sector has been hit by sharp budget cutbacks and low world oil prices.

Employment. In these circumstances, employment pressures—particularly for unskilled labor—have become severe. Private-sector economists in Mexico estimate that 1 to 2 million jobs have been lost since mid-1982 and that unemployment is now in the 20- to 30-percent range. While government authorities claim the figures are lower, they admitted in May that the unemployment rate had doubled during the last year. Job losses have thus far been concentrated in the private sector. Based on preliminary official data, we believe government jobs stayed constant or increased slightly because of the $2.7 billion public works program announced by Mexico City last January.

Inflation. Inflation remains in the triple-digit range despite the recession and much higher unemployment. In January-June consumer prices rose 41 percent, an annualized rate of 100 percent, fueled by the soaring peso cost of imports, mounting consumer goods shortages, and the still high budget deficit. Wholesale prices rose substantially faster—at an annualized rate of 133 percent—as a result of raw material shortages, lower input subsidies, and fewer price controls.

Selling Austerity

Public Relations Efforts. Recent public opionion polling indicates that the President's low-key and down-to-business style, his vigorous attack on inefficient policies, and his measures to curb official abuses of power have convinced many Mexicans that belt tightening is essential. To maintain the cooperation of organized labor, business, and the middle class, the government is attempting to improve its reputation for honesty, efficiency, and fairness, and ensure that austerity is shared equally. A vigorous anticorruption campaign has even targeted key ruling party loyalists. De la Madrid's National Development Plan, published 30 May, is a major effort to retain public support for belt tightening. The plan suggests that 18 more months of tough austerity are needed but that equity will be considered and living standards of the poor improved, in part by eliminating privileges of the rich.

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Private-Sector Hesitation. The middle class and private business have been pleased with de la Madrid's lack of rhetoric, his nonconfrontational style, and the anticorruption campaign, but they are concerned about the absence of an explicit role for private enterprise in the development plan. Even though the plan does not specifically call for more nationalizations, many businessmen believe government ownership of Mexico's productive capacity will increase. Mexican and US economists doubt the government's ability to greatly increase nonoil exports in the short or medium term—as the plan calls for—without substantial support from private business.

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Winning Over Organized Labor. We continue to believe that retaining support of organized labor remains key to keeping austerity going. Gaining and maintaining unions' support thus far has been—in our opinion—de la Madrid's most notable achievement. Official labor unions have remained quiet despite the administration's unwillingness to make concessions on wages. In January, minimum wages were raised just 25 percent and in June only 15.6 percent. These increases lag far behind the rise in the cost of living.

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The President also has taken a hardline stance with small Communist-dominated unions. According to press and US Embassy reports, a monthlong strike by nonacademic employees of the National University, organized into Mexico's largest Communist-led labor union, ended in early July without a pay increase for the strikers. The administration was inflexible during bargaining sessions and was prepared to terminate the workers' contracts. Members of another leftist union were undercut by the announced liquidation of the government-owned company they were striking [redacted]

Limited Progress on Debt Rescheduling

The IMF stabilization package—purchased at the short-term cost of economic austerity and possible social unrest—was intended to open a window to reschedule Mexico's mammoth foreign debt. Nonetheless, debt rescheduling efforts continue to slip. [redacted] many Mexican officials and foreign bankers believe that the 15 August deadline for restructuring public-sector debt is unrealistic. Many public-sector agencies have not yet begun to work out individual terms with representatives of the banks. While most of the public-sector debt of some $67 billion will eventually be rescheduled, few bankers are pleased with the terms offered on $19.5 billion in arrearages and debt payments on public debt due through 1984. [redacted]

Even less has been accomplished in efforts to restructure private debt. The US Embassy recently estimated that as of mid-June only $200 million—of the $9 billion to be renegotiated—has been rescheduled despite Mexico City's offer to guarantee availability of foreign exchange to pay private-sector debt for loans rescheduled over six to eight years. The recent headway on Mexico's foreign accounts has encouraged the international financial community somewhat, but, because of the continued capital flight and problems in reducing debt arrearages, bankers remain skeptical about the government's ability to provide foreign exchange to pay private debt obligations. [redacted]

While Mexico has largely stayed current on public-sector interest obligations, the substantial interest arrearages owed by the private sector continue to grow. Over the last six months, government efforts to help the private sector reduce arrearages on interest obligations have been only partially successful because of the illiquidity of many Mexican firms and government foreign exchange shortages. As a result, we estimate that the past-due interest on private-sector debt during this time rose by $200 million to some $1.2 billion. [redacted] 25X1

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Outlook for the Remainder of the Year

We project that the economic decline will persist throughout this year, whether de la Madrid eases up on austerity or not:

- If Mexico City backslides, and we put the odds at a little better than even that it will, GDP would 25X1

Mexico: Impact of Economic Deterioration, 1983

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	Relaxed Austerity [a]	Continued Tough Austerity [b]
Change in GDP (*percent*)	−5	−8
Job losses (*millions*)	1.5	2.0
Inflation (*percent*)	115	90
Change in real merchandise imports (*percent*)	−25	−50
Decline in supplies of locally available goods and services (*percent*)	−7	−13
Change in investment (*percent*)	−15	−35
Change in per capita consumption (*percent*)	−7 −7	−10 −10
Current account balance (*billion US $*)	−0.5	3.5
Free market exchange rate, yearend (*pesos per US $*)	150 to 200	200 to 300

[a] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[b] Assumes Mexico City keeps imports and public spending depressed.

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[redacted] 25X1

decline 5 percent and consumption would dip 7 percent.

- On the other hand, if de la Madrid moves to maintain austerity, we see GDP falling 8 percent this year and personal consumption plummeting 10 percent.

Current estimates of changes in key economic variables by US econometric services and by the Mexican Government are nearly, but not quite, as pessimistic as our own, while the IMF is still holding to its initial economic growth and inflation projections.

The Relaxation Case. By relaxing austerity to boost imports and spending, we believe that Mexico City can stem—but not halt—the steep slide in the economy by yearend. Divisions among government officials over whether this should be done are growing. Many Mexican economists, business and nonestablishment labor leaders, and opposition politicians also are arguing that the adjustments have gone far enough.

Mexico would be able to slow the sharp drop in imports this year with improved first-half foreign exchange reserves and a renewing of some trade credit lines. This would relieve some critical shortages and enable some plants to raise production slightly. Even so, import volume is likely to be at best 25 percent below last year's result, and nearly 60 percent lower than the 1981 level. We would expect most businessmen to maintain a "wait and see" attitude before making substantial new commitments to purchase imports because they are suspicious of de la Madrid's commitment to private enterprise. 25X1

In our judgment, it is more likely that the government itself would provide the principal stimulation to the economy. Increasing public spending enough to boost the budget deficit as a share of GDP 3 or 4 percentage points from the current 10-percent rate would slow the decline in economic activity by about one-third for the year. Higher public spending would spur both investment and consumption. 25X1

Mexico: Forecasts of Key Economic Variables, 1983

	Change in GDP (*percent*)	Inflation (*percent*)	Current Account Balance (*billion US $*)	Imports (*billion US $*)	Exports (*billion US $*)
Data Resources [a]	−4.4	110	−2.9	13.2	21.1
Wharton Econometric Forecasting [b]	−5.1	101	−0.8	11.8	20.6
Mexican Government [c]	−2 to −4	77	−1.0	13.8	22.3
International Monetary Fund [d]	NEGL	55	−2.0	14.5	22.6
Central Intelligence Agency	−5 [e] −8 [f]	115 [e] 90 [f]	−0.5 [e] 3.5 [f]	12.0 [e] 8.0 [f]	21.8 [e] 21.5 [f]

[a] Latin America Review Second Quarter 1983, Data Resources, Inc., June 1983.
[b] Latin America Outlook, Summer 1983, Wharton Econometric Forecasting Associates, July 1983.
[c] From National Development Plan, May 1983.
[d] IMF Staff Report, 9 May 1983.
[e] Assumes Mexican policymakers relax austerity by increasing imports and public spending.
[f] Assumes Mexico City keeps imports and public spending depressed.

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We believe, however, that any substantial rebound in government spending would aggravate inflation and boost the increase in consumer prices to an annual rate of 130 percent in July-December.

Sticking to the IMF Program. If de la Madrid stands firm on austerity, import volumes would stay at rock bottom, and the economic slide would accelerate. In this case, we project real imports in 1983 would fall 50 percent below last year, and almost 75 percent below the 1981 level. While industries would continue drawing down nearly depleted inventories, capacity utilization would drop to less than half. As a result, locally available supplies of goods and services would decline further. 25X1

With continued budget cuts and the contraction of demand, we expect that inflationary pressure would ease somewhat, and the increase in the cost of living would average some 80 percent for July-December. This, along with a more favorable foreign exchange position, should make it possible for economic recovery to begin by late 1984.

Implications for the United States

Prospects for prolonged austerity, a continued falloff in consumption, and mounting political pressures will cloud US-Mexican economic and political relations for at least the next two years. Despite substantial improvements in bilateral economic relations since de la Madrid took office last winter, grating bilateral episodes—such as an expropriation of properties owned by US firms or additional debt moratoriums—are still possible, particularly if the United States is blamed for increasingly poor economic performance

We believe Mexico City's principal bilateral concern will still be to preserve Washington's backing in the international financial negotiations. De la Madrid has indicated his gratitude for the US leadership in arranging new financial credits and the progress on debt relief. Mexico City expects US officials to back its efforts to maintain austerity with additional credits from the Commodity Credit Corporation and help in restoring trade credits. In addition, Mexico will call for the United States to intercede with the IMF and international banks if it seeks to adjust the stabilization program and to obtain new loans over the next few years. 25X1 25X1

US-Mexican economic relations will suffer in several areas. We expect private-sector Mexican bankruptcies to cause US banks to write off $3-4 billion in bad debt over the next year or so. US exports to Mexico—our third-largest trade partner—will fall by $4-5 billion this year, after dropping $6 billion in 1982. US-owned businesses in Mexico that produce for the domestic market—the majority of the $7 billion US investment—will continue to face poor demand, and many will pull out because of mounting losses. Meanwhile, illegal migration to the United States will remain at record levels. 25X1

On the positive side, US-owned assembly operations along the border that process goods for reexport to the United States will increase profits because of lower real wages and the weak peso. During the next several years, the Mexican Government will be taking steps to keep US businesses operating so that the companies' home offices will still subsidize Mexican losses. Mexico City has already announced that to spur increased production for exports it will adjust rules and interpret its foreign investment laws liberally. 25X1

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